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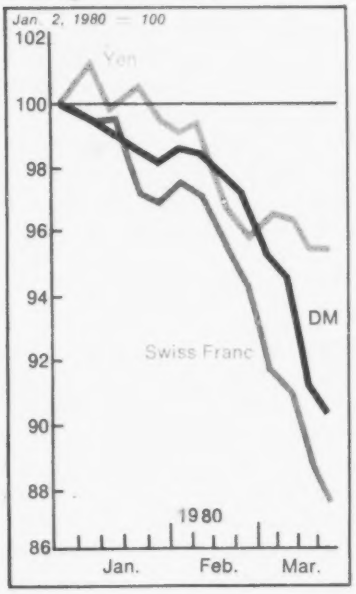
The Strong Dollar Creates Problems

The dollar problem is pinching once again, but now the shoes are on other feet. This time it is not the United States that is facing the threat of imported inflation and loss of freedom with respect to domestic monetary policy, but rather Germany and Japan—the strong-currency countries of recent years. Since the beginning of January, the dollar has appreciated roughly 10% against the Deutschemark, 13% against the Swiss franc, and 4% against the Japanese yen. These exchange-rate movements have added to the rapid increase in the local-currency cost of imported goods, which has been the primary factor behind the acceleration of consumer-price inflation in these countries. And dollar strength has played a pivotal role in influencing the adoption of monetary policies abroad that have become tighter than most foreign policymakers would have preferred at this time.

Dollar cost of selected foreign currencies



The policy responses in those countries most affected by the strengthening dollar have been similar. Short-term interest rates have been pushed up, the access of foreign investors to local financial markets has been liberalized, off-market exchanges of domestic-currency denominated securities for dollars are being negotiated with OPEC surplus countries, and extensive intervention in foreign-exchange markets has been carried out. To some observers, these actions amount to a reversal of long-standing policies aimed at preventing these currencies from assuming a wider international role. This characterization seems extreme. The recent policy moves are essentially currency-defense packages that can be expected to be reversed when the balance of forces affecting the dollar changes sign.

A second perception that seems exaggerated is the notion that the period of troublesome dollar strength is likely to be protracted. The recent surge of the dollar has derived primarily from the emergence of unusually wide interest-rate differentials. The foreign-exchange market views these differentials as favoring dollar-denominated assets to an abnormal degree, given expectations as to underlying inflation rates. Projection of the course of U.S. interest rates in the coming months is extremely hazardous, and there is certainly no consensus as to whether these interest-rate differentials will widen or narrow in the short run. But it does seem a fair bet that the current wide disparity in interest rates will not persist for an extended period.

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Dutch under strong pressure to enhance trade performance.

The Dutch current account is estimated to have posted a deficit of 4.5 billion guilders in 1979, well above the $1.5-billion guilder official estimate offered at the start of 1980. Largely responsible for the marked deterioration are the rise in oil prices in the fourth quarter of last year and delays in raising the price of Holland's natural gas exports. Private forecasters fear a current-account gap as large as 5 billion guilders in 1980, giving added urgency to efforts to improve export competitiveness. In this context, the recently proposed incomes policy, which most expect to be approved by parliament and which will restrict real wage increases for all but the low-paid to less than 1%, should have a positive impact on the 1980 trade accounts. The policy is expected to prevent a further deterioration in export competitiveness and restrict the growth of aggregate demand, now forecast to rise by 1% in real terms this year.

Rising inflation in Norway complicates wage bargaining.

Increasing oil production helped swing the Norwegian trade account into a surplus of 330 million kroner in February, after January's kr. 84-million deficit. The trade-account improvement triggered healthy demand for the kroner on foreign-exchange markets, leading the central bank to intervene to dampen upward pressure. The future, however, looks somewhat less rosy. Consumer prices have begun to accelerate sharply, with prices rising 1.4% in January and 1.3% in February. The increased pace of inflation is threatening the current wage negotiations, and some labor groups have already struck for immediate pay raises, refusing to wait until the negotiations are concluded. Other similar labor actions underscore the restiveness of the workforce. If wage settlements come in at high levels, the competitiveness of Norway's traditional industries will be hurt, thereby threatening a rise in unemployment as the year progresses.

Portuguese authorities set ambitious 1980 growth targets.

Portugal's current account staged a major recovery in 1979, shifting into surplus as a result of strong growth in tourism, manufacturing exports, and worker remittances. The economic program of the newly elected government seeks to build on this performance, in the hope of making a solid and immediate impact before the required 1980 general election. Government targets for 1980 specify a reduction in annualized inflation from 24% to 20%, an increase in economic growth of 2.5%-3.5%, and—for the first time since 1975—no decline in real wages. The escudo was revalued by 6% in February, but the monthly crawling peg devaluations of 0.75% will remain in effect. The net impact of this, together with continuing price controls and subsidies, is expected to be a slower pace of inflation without significant erosion of export competitiveness. The growth targets, however, appear overly ambitious in light of the world economic slowdown and sustained domestic monetary restraint.

Japan responds to mounting inflation with new program.

Faced with accelerating inflation, the Japanese Government announced another anti-inflation package. The new plan is designed to hold the rate of price increases to within the official target of 6.4% for fiscal 1980/81. In addition to a record rise in the discount rate to 9% and generally tighter monetary policy, a more stringent fiscal policy will be implemented. Some public work projects will be postponed, public services charges will be reduced, and energy and land price rises will be monitored closely. The Government also intends to stabilize food prices by modernizing production and distribution methods; it may also increase beef and marine product imports to ease shortages. The anti-inflation package, however, lacks the specific measures that will be taken by the Government to achieve its goals; thus, there is some doubt as to whether the program will have a significant impact on the economy. Assuming that the effects are limited, Japan's inflation rate for the next fiscal year will very likely be in the 9%-10% range.

Hong Kong looks forward to continued high growth.

The Hong Kong Government anticipates continued prosperity in 1980. The authorities project that GNP will advance by 9%, compared with 11.5% growth in 1979, and that the rate of consumer price inflation will decline from the 11.6% rate of last year to about 10%. Private and public property development and business and financial services will remain the leading sectors of the economy, buoyed by the gathering momentum of Chinese economic development. China-related business is expected to moderate the impact of economic sluggishness in the Western economies. Nevertheless, exports are unlikely to grow by more than 7% in real terms, versus 16.6% growth in 1979. Imports, however, will advance about 11%, and a trade deficit exceeding $2 billion is anticipated. Invisible earnings and investment inflows are expected to cover the trade gap, thereby maintaining stability in the Hong Kong dollar's exchange rate.

Colombian reserves reach historic high.

Colombia's official international reserves rose by $1.6 billion in 1979—much greater than the two previous years combined—to a record $4.1 billion. This unusually strong performance is attributable to gains in both the current and capital accounts of the balance of payments. Specifically, significant advances in non-coffee exports and service earnings widened the current-account surplus from $800 million in 1978 to $1.2 billion last year. At the same time, higher levels of public and private foreign borrowing produced a capital-account surplus of $465 million in 1979, compared with deficits averaging $155 million annually in the previous two years. The growth in international reserves is putting pressure on the expansion of the monetary aggregates, although the rate of inflation has eased in the past two months.

Cameroon's rising oil output improves medium-term balance-of-payments outlook.

While still highly dependent on cocoa and coffee for foreign-exchange earnings, Cameroon is about to enter a period of stepped-up oil production and exports, followed by export diversification. In 1979, the oil account is estimated to have been in approximate balance, as export receipts for about 1.2 million tons of crude were offset by import payments for refined oil products. By 1982, Cameroon's domestic oil needs, projected to rise to one million tons, should be supplied entirely by the new Victoria refinery. As production is forecast to reach 3-3.5 million tons in 1982, net oil receipts could approach $1 billion. Furthermore, recent offshore oil finds give rise to production forecasts of 5 million tons by 1983-84, with a possible doubling by the end of the decade. Given Cameroon's conservative economic management, substantial current-account surpluses are foreseen for the mid-1980s, which should facilitate the infrastructural development needed to exploit the country's rich natural resources. This should broaden the export base and reduce dependence on agricultural exports for foreign-exchange earnings.

Gold fever turns to chill.

The precious metals markets have become increasingly volatile as the United States and other economies appear poised on the brink of a recession, with accelerating inflation and rising interest rates. Gold's price soared to over $850 per ounce in January from year-earlier levels of slightly more than $200. Since then, prices have fallen back to the $500-range, despite higher rates of inflation. The reasons for the price decline include an easing of the war anxiety that was sparked by the Soviet invasion of Afghanistan, a rise in the value of the dollar in response to sharply higher interest rates, and the imposition of credit controls and stepped-up efforts by both the Carter Administration and Congress to balance the U.S. budget. Although gold prices may recover again in coming months if prospects for inflation worsen, the dollar weakens, or new political turmoil erupts—especially in the Mid-East—the most likely gold price trend over the next year is downward. This assumes that the much-heralded recession arrives soon, as is expected, and that inflation begins to subside later in the year.

Housing's Foundation Gives Way

Although the U.S. economy has so far stubbornly resisted recession, the housing industry is headed for one of its worst years since 1946. Housing units were started at a seasonally adjusted annual rate of 1.33 million in February, almost 30% below September 1979. And the turnover rate of new houses has slowed about 20%. Further, the sales rate for existing houses has fallen about 25% to a seasonally adjusted annual rate of 2.95 million in February, the lowest rate since May 1976.

Housing activity had started to slow somewhat during the first nine months of 1979. Starts and sales of new housing units were off about 10% from the corresponding 1978 level, but the sales pace of existing homes was off by only 5%. As mortgage rates moved over 10% and approached 12% in many areas, many observers were amazed that activity did not fall off more. The reason for the resilience has much to do with the fact that the annual rate of price increases of new and existing houses was averaging about 15%. Thus, demand for housing and mortgage credit remained high as people sought to purchase homes as a hedge against further inflation. And the success of the six-month money market certificates, along with other short-term borrowing, allowed thrift institutions and banks to increase the supply of long-term mortgages.

Several factors in the last six months have dramatically altered the perspective of both borrowers and lenders. First, mortgage rates climbed past 12% (and beyond 13% in some areas) in the wake of Federal Reserve actions to tighten credit in October 1979, smacking up against mortgage usury ceilings in many states. Congressional action suspended these ceilings as of January 1, 1980. But even without such constraints, the incentives for thrift institutions to issue new commitments were drastically reduced. Earnings were squeezed as interest obligations on money-market certificates and other short-term borrowings rose faster than the average yield on mortgage portfolios. Second, as income gains lagged inflation and the sharp increase in mortgage rates, fewer and fewer households qualified for mortgage credit. And as housing markets weakened, price increases moderated to an annual rate of about 11%, easing some of the speculative demand.

Both short-term interest rates and mortgage rates have moved sharply higher in early 1980. Thus, the reduced availability of loanable mortgage funds, along with some reduction in mortgages demanded by borrowers, will bring housing activity to still lower levels in the months ahead. Building permits for new housing units were 8% lower in February than in January, signaling a further drop in residential construction activity in March. Outstanding commitments at savings and loan institutions continue to fall. And as the rest of the economy follows housing into recession, weak income gains and rising unemployment will dampen home demand still further.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE O				
		3-months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of credit, lions of
Austria	Economy slowing as inflation accelerates; economic growth forecast at 2% for 1980.	Aug.	+ 8.9%	68.9	+ 5.3%	Jan.	3,758	— 14.0%	2.3	
Belgium	Domestic demand set to weaken; rise in budget deficit expected.	Nov.	+ 3.1%	111.5	+ 3.0%	Jan.	5,501	+ 34.4%	1.1	
Britain	Indicators point to recession, but demand and output have yet to decline.	Nov.	+ 1.9%	391.2	+ 0.5%	Jan.	20,531	+ 23.9%	2.4	98
Denmark	Little economic growth anticipated for 1980; fiscal policy restrictive.	Sept.	+ 6.6%	65.6	+ 2.5%	Jan.	2,767	— 21.1%	1.8	
Finland	Official forecasts project a slowdown, but businesses report strong orders.	Nov.	+ 8.1%	41.6	+ 7.3%	Jan.	1,743	+ 27.7%	1.8	8
France	Worsening inflation further erodes confidence; growth prospects for 1980 revised downward.	Nov.	+ 3.6%	566.9	+ 3.0%	Jan.	19,576	+ 96.2%	2.2	
Germany	January orders remain strong, but building sector weakens.	Dec.	+ 5.7%	755.8	+ 4.3%	Jan.	51,602	+ 10.4%	3.9	
Greece	Economy overheating, with inflation rate exceeding 20%.	Sept.	+ 6.1%	37.5	+ 3.5%	Nov.	956	— 4.1%	1.4	18
Ireland	New central bank forecast calls for GDP growth of less than 1% in 1980.	Aug.	+ 6.4%	14.9	+ 3.3%	Jan.	2,224	— 11.3%	2.7	
Italy	Inflation year-to-year now exceeding 20%, with no immediate relief in sight.	Nov.	+ 7.3%	318.6	+ 4.0%	Jan.	19,654	+ 63.0%	3.1	
Netherlands	Economic growth about to slow; investment weakness anticipated.	Dec.	+ 2.1%	151.8	+ 3.3%	Jan.	8,485	+ 60.1%	1.5	
Norway	Oil development sustains rapid GDP growth; inflation surges.	Dec.	+ 0.7%	45.3	+ 2.8%	Jan.	4,238	+ 36.1%	3.7	
Portugal	Economic growth is forecast to remain at 2.5% as second general election approaches.	June	+ 7.2%	20.2	+ 3.0%	Dec.	940	+ 7.9%	2.0	20
Spain	Recession anticipated, with 1980 economic growth estimated at 0.5%.	June '78	+ 5.4%	197.4	+ 1.5%	Dec.	13,224	+ 30.8%	6.7	27
Sweden	Government cutting spending and reducing subsidies to ailing industries.	Nov.	+ 6.3%	103.3	+ 4.0%	Jan.	3,489	— 13.0%	1.4	
Switzerland	Industrial surveys point to continued output growth in first-half 1980.	Dec.	+ 4.0%	94.1	+ 0.3%	Jan.	13,373	— 25.7%	5.3	
Canada	Slow economic growth expected, but inflation holding below 10%; business investment strengthening.	Nov.	+ 3.1%	260.5	+ 2.9%	Feb.	3,472	+ 11.4%	0.6	
United States	New anti-inflation program to worsen growth prospects before reducing price pressures.	Feb.	+ 0.7%	2,349.0	+ 2.0%	Jan.	9,790	+ 10.3%	0.5	

Near-Term Money Bulge Anticipated

Although money growth has moderated considerably in March from its torrid February pace, tax-related and other seasonal forces may produce a bulge in the money supply sometime in the next few weeks. Most money supply forecasters are projecting that both M_{1a} and M_{1b} will grow at or near double-digit annualized rates in April. While such an outcome would suggest that any significant near-term easing in money market rates is unlikely, the extent to which it would precipitate further credit-tightening moves by the Federal Reserve remains unclear.

One reason to anticipate a near-term jump in the money supply is that disbursements of Federal income tax refunds, sizable since the end of February, are expected to be exceptionally large from now through at least the end of April. Tax refunds affect the narrowly-defined monetary aggregates because a significant portions of these refunds are initially deposited in checking accounts—the largest component of both M_{1a} and M_{1b}.

The last time tax refunds were extraordinarily large—when rebates were disbursed in May and June of 1975—M_1 spurted temporarily, with preliminary M_1 growth reported at almost 11% in May and 18% in June. While the magnitude of this year's tax refunds will not match those of 1975, some upward impact on money growth is likely. Indeed, it was specifically noted in the minutes of the February meeting of the Federal Reserve Open Market Committee (FOMC) that such a tax-related money bulge could occur.

Seasonal adjustments contribute another potential source of near-term strength in money growth. Current seasonal factors used to adjust the monetary aggregates do not appear to account adequately for the upward effect of seasonal forces on April money growth. Even after seasonal adjustment, April money growth in the last three years has significantly exceeded trend money growth rates.

Another near-term jump in the monetary aggregates will put them near or above the level implied by the upper-bound of their long-run target growth ranges. The extent to which the Fed would tighten interest rates further in response to such a bulge, however, is uncertain. The FOMC recognized at its February meeting that tax refunds might affect money growth in the March-April period, and this was probably taken into account when the FOMC raised the upper limit of the trading range for the Federal funds rate from 15½% to 18% from February 22 through March 7. Indeed, it is possible that this rapid increase in money market rates will, by reducing money demand, partly offset the effect of tax-related and seasonal forces on money growth. Moreover, the FOMC may feel that the transitory nature of such a bulge does not warrant any significant policy move. Unfortunately, the near-term targets for money growth set at the March FOMC meeting are not yet known. Consequently, the extent to which these targets allow for any "tax-refund" effect remains to be seen.

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
IF li- lers	current influences on payments	latest data	consumer prices	latest data	domestic credit	March 26, 1980		current monetary conditions	
	Export prospects dimmed by German slowdown.	Dec.	+ 4.7%	Nov.	+17.0%	5.25%	.0735	Interest rates rising.	Austria
	Widening current-account gap expected as export growth slows.	Jan.	+ 6.0%	Sept.	+13.2%	14.00%	.032785	Interest rates rise to support franc.	Belgium
	Strong pound keeps exports weak and current account in deficit.	Feb.	+16.1%	Oct.	+17.1%	17.00%	2.1780	Credit very tight, despite efforts to boost liquidity.	Britain
	No improvement in current-account deficit anticipated in 1980.	Dec.	+11.8%	Oct.	+10.1%	13.00%	.1688	Discount rate stands at a record 13%.	Denmark
	Trade gap of 624 million markkaa posted in January.	Dec.	+ 8.6%	Nov.	+17.4%	8.50%	.2605	Credit tightened with call for special deposits on Feb. 27.	Finland
	Higher oil bill pushes current account into deficit.	Feb.	+14.1%	Jan. '79	+10.9%	9.50%	.2275	Money conditions remain tight in support of franc.	France
	Current-account gap of DM 20 billion expected in 1980.	Feb.	+ 5.6%	Nov.	+12.6%	7.00%	.5272	Discount and Lombard rates raised to support the mark.	Germany
	Large current-account gap prompts heavy Euromarket borrowing.	Nov.	+22.7%	Aug.	+22.2%	19.00%	.0250	Credit conditions restrictive.	Greece
	Expected GDP slowdown should sustain 1979's $1.5-bn. current-account gap.	Nov.	+16.0%	Dec.	+27.5%	16.40%	1.9735	Private credit growth target a restrictive 13%.	Ireland
	Average monthly trade deficit for last three months tops $1 billion.	Feb.	+21.7%	Apr.	+14.8%	15.00%	.001137	Interest rates to rise further.	Italy
	Costly oil boosts 1979 current-account gap to 4.5 billion guilders.	Dec.	+ 4.8%	Oct.	+16.1%	9.50%	.4807	Rates ease somewhat as guilder strengthens in EMS.	Netherlands
	Jan. trade gap was kr. 64 billion, versus 267 million in Jan. 1979.	Jan.	+ 6.2%	Oct.	+16.1%	9.00%	.1965	Kroner strong on foreign-exchange markets.	Norway
	Revaluation likely to produce small current-account deficit in 1980.	Dec.	+22.4%	Oct.	+21.2%	17.00%	.0200	Credit restrictions ease only slightly.	Portugal
	Current-account gap of $1.5 billion forecast for 1980, due to costly oil.	Nov.	+15.4%	Nov.	+17.2%	8.00%	.0142	Monetary conditions remain restrictive.	Spain
	Trade gap of kr. 1.6 billion in Jan., versus kr. 200 million in Dec. 1979.	Dec.	+ 9.8%	Sept.	+22.8%	9.00%	.2270	Tight credit policy spurs capital inflow, boosting reserves.	Sweden
	Substantial reduction in current-account surplus expected this year.	Feb.	+ 4.1%	Nov.	+12.5%	3.00%	.5571	Domestic liquidity reduced further.	Switzerland
	Government may review foreign investment rules.	Feb.	+ 9.4%	Jan.	+24.3%	14.79%*	.8417	Central bank adopts floating discount-rate policy.	Canada
	Current-account gap narrows, but looks set to deteriorate.	Feb.	+14.2%	Jan.	+11.1%	13.00%**	—	High money market rates bolster dollar.	United States

* Floating at ¼% point above average yield on 91-day Canadian T-bills.

** 16.00% for large banks that are regular users.

World Interest Rates

market rates of March 26, 1980; bond yields as of March 21, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00*	14.79	17.00	14.00	9.50	7.00	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	18.50 March 27	15.00	17.75	13.20	13.00	8.50	16.625	10.25	3.00	12.3125
Treasury Bills 91-day, Middle Rates	15.90	14.80	16.0625	17.50	n. a.	n. a.	14.90 95-day	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	15.125 finance paper 15% tax w/h	15.52	13.90 Certified	14.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.95	15.00 15% tax w/h	17.25	15.25 Certified	not traded	9.40	19.30	no market	0.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	12.37	13.90	14.40	12.65 20% tax w/h	13.31	9.85	14.95	11.26	5.09	9.43
Industrial Bonds prime, long-term, new and old issues, average yield	13.20 Aa Industrials	14.20	14.87	n. a.	14.74	9.89	14.79	12.35	6.16	7.32
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	15.75	18.00	18.75	14.85	10.75	20.00	13.50	4.50	9.25
Bank Time Deposits 3-month	17.125 Cert. of Dep.	14.95 Cert. of Dep.	17.8125	17.70	14.0625	9.50	10.75	11.375 large deposits	7.125 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	19.00	no market	18.875	no market	14.50	9.75	no market	11.25	7.1875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8417	2.1780	.032785	.2275	.5272	.001137	.4807	.5571	.004015
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.875 *P*	.25 *P*	1.375 *P*	4.00 *P*	9.00 *P*	.50 *D*	7.75 *P*	11.75 *P*	2.00 *P*

Eurodollar Deposits
(London, interbank, bid)
March 27

7-day	16.50
1-month	17.875
3-month	19.0625
6-month	18.00

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .19
U.S.-Canada Treasury Bills	−2.05
U.S.-Canada Finance Co. Paper	−3.75
Eurodollars-U.K. Local Auth. Deposits	+ .06

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.125
DM Bonds	
7 yrs. and under	10.00
Over 7 yrs.	10.125

Gold Price

London afternoon fixing

507.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* 16.00% for large banks that are regular users.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.2 (Feb.)	9.4 (Feb.)	16.1 (Feb.)	14.1 (Feb.)	5.6 (Feb.)	21.7 (Feb.)	4.1 (Feb.)	7.6 (Feb.)
Industrial production*	0.7 (Feb.)	−0.4 (Jan.)	8.5 (Jan.)	1.5 (Jan.)	16.7 (Jan.)	7.9 (Jan.)	4.0 (Dec.)	9.7 (Jan.)
Trade balance† *(billions of local currency units)*	−$5.57 (Feb.)	C$.27 (Jan.)	−£.23 (Feb.)	−FF4.27 (Feb.)	DM.342 (Jan.)	−Lit.1,130 (Jan.)	−SF1.11 (Feb.)	−¥180 (Feb.)
Money supply (M_1)*	8.9 (Feb.)	6.7 (Feb.)	7.3 (Jan.)	10.9 (Nov.)	1.3 (Jan.)	25.5 (Nov.)	−2.4 (Nov.)	11.4 (Dec.)
Velocity of money (M_1)*	3.9 (Dec.)	5.2 (Sept.)	4.8 (Sept.)	11.5 (Sept.)	0.1 (Sept.)	−3.1 (June)	n.a.	−2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	+2,034 (Jan.)	+192 (Jan.)	+667 (Jan.)	+1,997 (Jan.)	−947 (Jan.)	+1,492 (Jan.)	−3,062 (Jan.)	+1,492 (Jan.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Ecuador Pursuing Steady Development

Ecuador is making sustained progress in the transformation of its economy. The country's gross domestic product reached $9 billion last year, a 5.3% real increase over 1978. And per capita income edged over $1,000—a significant achievement since the comparable figure was less than $300 just a decade ago.

Petroleum has provided the major thrust for Ecuador's economic development since 1972. Income from this source, combined with increased earnings from other commodity exports and the start-up of new industrial plants, has kept the economy's compounded average annual GDP growth rate at 7.5% during the 1970-79 period, well above the 5.5% average growth rate of the late 1960s. This faster growth has been accompanied by structural shifts in Ecuador's economy. In 1970, agriculture was the dominant economic sector, contributing 27% to real GDP. By 1980, however, manufacturing emerged as the major sector, accounting for 21% of GDP, while agriculture's share dropped below 20%. The petroleum industry, which is responsible for about half of total export earnings and a large share of government revenue, has increased its share of GDP from 1% in 1970 to 6% this year. Nonetheless, the country remains in the developing stages, evidenced by the dualism of economic activity (i.e., thriving modern and traditional sectors) and the large share of the labor force (over 50%) engaged in agriculture.

Aside from a drought-induced decline of 2.6% in agricultural output last year, all other sectors of the economy advanced fairly well. The utilities grew the strongest, more than 12%, while manufacturing posted real growth of over 10% for the third consecutive year. The brisk pace of economic activity has brought rising consumer incomes, and this, together with new entrants into the money economy, has contributed to increased consumer product sales.

Inflation moderated in 1979; price increases averaged 10.3%, compared with 13.3% in 1978. This was largely the result of the Government's cautious policy in the face of rising demand pressures. Both fiscal and monetary policies were somewhat restrictive in 1979, in order to stem strong upward price pressure. A cautious policy on wage increases, price controls, and subsidies on certain staples curbed the rate of price advances throughout the year.

The inflation outlook for 1980 is less encouraging. A doubling of the minimum wage from $80 to $160 per month became effective January 1, and it is expected to contribute heavily to the build-up of inflationary pressures. The impact on prices is already evident; the annualized inflation rate rose from 10% in December 1979 to 10.5% in January.

The huge OPEC oil price rises boosted this OPEC member's oil export earnings substantially in 1979. The merchandise trade surplus rose from $219 million in 1978 to nearly $300 million last year. With the average per-barrel price of oil about $25 last year, compared with $13 in 1978, exports of 44.7 million barrels earned revenue of slightly more than $1 billion in 1979. Contract and spot prices for Ecuadorean oil climbed as high as $40 per barrel in December 1979.

The impact of the near-doubling of oil export earnings in 1979 was sufficient to compensate for a 28% increase in imports and still produce an expanded trade surplus. This despite the fact that the volume of petroleum exports was slightly lower than in 1979, owing to a 15% increase in domestic consumption.

The improved trade balance, to be sure, was not due entirely to petroleum. Non-oil export receipts rose by almost 11%—admittedly, also mostly the result of world price increases rather than volume gains. Of the non-oil exports, the sharpest earnings increases were for bananas, wood, fish products, processed cocoa, instant coffee, household appliances, and manufactured goods.

The outlook through 1984

The near-term outlook will be determined to a great degree by the new National Development Plan (1980-84). The plan calls for greater emphasis on energy, agriculture, and social development. It also aims to apply increased resources to alleviating the constraints on the country's future economic performance: problems with public-sector revenue gathering, the rising service payments on the external debt, inflationary pressures, agricultural stagnation, the too-rapid increase in domestic gasoline consumption, and the need to increase the dwindling level of oil reserves.

The plan projects average annual GDP growth of 6.5% for 1980-84, with a 5.3% growth projection for 1980. (Per capita income is expected to rise by 20% over the period.) Total plan investment expenditures are targeted at almost $15 billion in real terms over the five-year period; of this total, 40% will come from the public sector and it is hoped that the remaining 60% will come from private sources. The plan anticipates that domestic savings will increase its financing share of investment costs from 81% to 86%, with foreign capital providing the remainder.

While the drafters of Ecuador's ambitious development plan were initially criticized for not collaborating with the private sector in its preparation, local businessmen have generally responded positively to its contents. And although some are concerned about the impact of increased government spending, particularly on inflation, most businessmen see new opportunities for the private sector to play a larger role in Ecuador's future development.

A. Blake Friscia

Indonesian Reserve Pile-Up Poses Problems

Indonesian authorities are currently faced with an enviable problem: how to allocate the huge increases in the domestic economy's real income stemming from surging foreign-exchange earnings. Foreign-exchange reserves (excluding gold) are estimated at at least $5 billion as of March 31, the end of the fiscal year, up about $2.1 billion for the year and sufficient to cover the cost of roughly five months of imports.

The remarkable increase in reserves can be attributed to a combination of three influences:

1. Higher prices for oil exports. Gross oil export earnings are estimated at $9.5 billion for fiscal 1979/80, up 31.5% from the previous year.
2. Sharp price rises for non-oil commodity exports, including timber, rubber, tin, and coffee. Non-oil export earnings were $5.5 billion in FY 1979/80, up more than 38% from the year before. In addition, natural gas production and exports continue to increase; LNG export earnings exceeded $400 million in FY 1979/80, about 78% higher than the prior year.
3. The positive impact of a 33.6% devaluation of the Indonesian rupiah in late-November 1978.

The rupiah's devaluation was motivated by the fear that oil earnings were beginning a long-term decline. With production currently averaging about 1.59 million barrels per day, down from the 1977 daily production peak of 1.68 million, and domestic consumption increasing by about 12% annually, a devalued currency was seen as countering the anticipated decline in oil export receipts by boosting non-oil exports and curbing imports. But because of the unusually large spurt in oil prices in 1979, oil earnings rose to new heights, thereby compounding the benefits of the devaluation and flooding the Indonesian central bank coffers with foreign exchange.

Oil earnings not yet fully reflected

Even so, the full effect on earnings of the overall increase in oil prices is only now beginning to be felt. The average price of Indonesian crude was about $13.50 per barrel at the end of 1978. The price increased by $8.20—a 61% jump—by mid-November 1979, and by another $8.60, or 40%, between November and February 1980 when the price per barrel reached $30.30. With a lag of several months before price rises are reflected in earnings, the balance of payments for fiscal 1979/80 ended March 31 will reflect little if any of the price increments realized after mid-November 1979. Thus, even assuming an average oil price of just $19 per barrel, a current-account surplus of about $1 billion is estimated for FY 1979/80, in contrast to a deficit of $1.2 billion in FY 1978/79. Assuming an average oil price of $33 per barrel for the new fiscal year, reserves are projected to exceed $8 billion by end-March 1981, with the current-account surplus likely to top $2 billion.

The inflationary consequences

The negative aspect of the liquidity build-up, however, is higher inflation. Up until now, the Indonesian Government has managed to contain the inflationary effects of the surge in foreign-exchange earnings. The monetary authorities have kept a tight rein on the fiscal budget and on credit expansion. These efforts were supplemented by substantial outflows of short-term capital attributable to post-devaluation nervousness in the financial markets, which helped to contain the money supply. The net result was money supply growth of about 35% in 1979, a full eleven percentage points higher than the growth rate of 1978, but much lower than it could have been. The increase in consumer prices in 1979 was 30%, most of which was traceable to the devaluation's direct impact on import prices. The inflation rate slowed during the latter months of 1979, however; it averaged less than 1% per month from September through December.

The outlook for inflation in fiscal 1980/81 is not encouraging. First, short-term capital outflows are expected to slow or even reverse, as confidence in the rupiah gains. Second, the run-up in government revenues has led to further pressure for increased expenditures, prompting the Government to announce a budget for fiscal 1980/81 with expenditures 52% higher than in the fiscal year just ended. The most inflationary budgetary item is a 50% increase in the salaries of all government employees. There are also indications that a large number of capital projects, some on the backburner since 1975, may be undertaken as various foreign ministries and agencies are eager to proceed. The consumer price index will also have to absorb another round of oil-product price increases. The budget calls for a 40% increase in domestic oil prices effective in April.

Thus, expectations are for another rise in inflationary pressures over the next few months, with an increase in the inflation rate that could total 20%-25% for the year. Still, real economic growth in 1980 is expected to rise by about 7.5%, up from the 6.8% growth rate of 1979. Although oil output will remain at about its recent level, production increases are expected in both agriculture and industry, spurred by higher export earnings and more expansive fiscal policy.

Willard D. Sharpe
Chase Hong Kong